

Message Text

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INFO OCT-01 EA-11 ISO-00 TRSE-00 FRB-02 NEA-14 FEAE-00

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P R 261208Z JUN 74

FM AMEMBASSY LONDON

TO SECSTATE WASHDC PRIORITY 1578

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DEPARTMENT PASS TREASURY AND FRB

E.O. 11652:N/A

TAGS: EFIN, UK

SUBJECT: LONDON FINANCIAL MARKET COMMENTS ON ARAB FLOWS
AND EURO-CURRENCY DEVELOPMENTS

REF: LONDON 6724

BEGIN SUMMARY: THIS IS FOLLOW-UP BY TREASURY REP TO
REFERENCED MESSAGE. MARKET SOURCES REPORT CONTINUING
DEVELOPMENT OF MULTI-TIER EURODOLLAR MARKET. THEY ARE
CONCERNED ABOUT LONDON'S CONTINUING ABILITY TO ABSORB THE
ARAB FUNDS FLOWING IN, INCLUDING UNCERTAINTY ABOUT HOW TO
HANDLE MID-JULY OIL PAYMENTS. ABILITY THUS FAR TO PLACE
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THESE FUNDS IN U.S. FEDERAL FUNDS MARKET CITED BY SOME AS

A SAFETY VALVE. INVERTED YIELD CURVE AND OTHER ARAB LIQUIDITY PREFERENCES GIVEN AS RATIONALE FOR MOST OF ARAB DEPOSITS BEING PLACED AT CALL, ALTHOUGH SOME ARE GOING LONGER TERM. MAJOR BANKS HERE ARE BIDDING LOWER THAN MARKET, STILL RECEIVING HEAVY DEPOSITS; ASSUMPTION IS THAT ARABS MORE WORRIED ABOUT WHERE TO PLACE FUNDS THAN HOW MUCH THEY EARN. MAJOR U.S. COMMERCIAL BANKERS EXPRESS UNEASINESS ABOUT RISK OF TRANSFORMING THESE SHORT-TERM FUNDS INTO LONG TERM LENDING, BUT WHEN THEY DO, THEY LOOK FOR A SPREAD OF AT LEAST 3/4 OVER LIBO. STERLING RECEIVING SUPPORT FROM FOREIGN OIL COMPANIES' PURCHASES FOR PAYMENTS TO MIDDLE EAST, ALTHOUGH FUNDS RECHANNELED BACK DO NOT NECESSARILY STAY IN STERLING. LEVEL OF STERLING INTEREST RATES AGAINST DOLLAR SEEN AS VERY IMPORTANT IN DETERMINING STERLING EXCHANGE RATE. THIS MUCH SAID, MARKET IS BEARISH ON STERLING GIVEN U.K. ECONOMIC/POLITICAL SITUATION AND TRENDS. END SUMMARY

1. SINCE REPORT IN REFTTEL, THERE HAS BEEN NO DISCERNABLE CHANGE IN HOW ARAB FUNDS ARE PLACED, I.E. TO A SELECT GROUP OF PRIME-NAME FINANCIAL INSTITUTIONS, PRIMARILY COMMERCIAL BANKS, GENERALLY ON CALL OR VERY SHORT-TERM. WE ARE TOLD THAT THE INNER CIRCLE INCLUDES CHASE MANHATTAN FIRST NATIONAL CITY, MORGAN GUARANTY AND BANK OF AMERICA AMONG U.S. BANKS; BARCLAYS, NATIONAL WESTMINSTER, COUTTS, AND MORGAN GRENFELL AMONG U.K. BANKS; UNION BANK OF SWITZERLAND; PROBABLY BANQUE DE L'INDOCHINE AND CREDIT LYONNAISE; AND AT LEAST ONE OR TWO GERMAN BANKS, ALTHOUGH SOME SOURCES SAY GERMAN BANKS DO NOT APPEAR PARTICULARLY ACTIVE IN LONDON MARKET.

2. RATES LISTED IN PRESS AS BEING PAID ON BID SIDE CAN BE MISLEADING. AT THE MOMENT, THREE DIFFERENT MARKETS WITH DIFFERENT RATES ARE REPORTED TO BE OPERATING. ONE COM-PRISES INNER CIRCLE OF LARGE MONEY BANKS, SOME OF WHOM APPEAR TO BE TRYING TO KEEP OUT OF THE MARKET OR MINIMIZE DEPOSITS, I.E. THEY BID LOWER THAN MARKET AND STILL OBTAIN FUNDS FOR ONE-QUARTER TO THREE-EIGHTS (OR EVEN 100 BASIS POINTS OR MORE) BELOW NOMINAL RATES; THE SECOND TIER CON-SISTS OF SECOND-CLASS, NAME BANKS WHICH ARE OBTAINING LIMITED OFFICIAL USE

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FUNDS ONE-EIGHTH PERCENT OR MORE BELOW THOSE NOMINALLY QUOTED; THE THIRD CATEGORY CONSISTS OF SOME ITALIAN, LUXEMBOURG AND JAPANESE NAMES WHICH ARE HAVING TO PAY EITHER NOMINAL RATES OR HIGHER FOR FUNDS AND WHICH ARE TAKING ALL THEY CAN GET. THOSE FIRST TIER BANKS BIDDING LOW IN AN ATTEMPT TO KEEP DOWN INFLOW OF FUNDS REPORTEDLY INCLUDES THREE OF THE SIX LARGEST U.S. BANKS IN LONDON AND BOTH BARCLAYS AND MIDLAND.

3. IN REPLY TO OUR QUERIES ABOUT WHY EURODOLLAR RATES DO NOT DECLINE AS RESULT OF INFLUX OF ARAB FUNDS, SOURCES REPORT THAT ONE MAIN ELEMENT HOLDING UP EURODOLLAR RATES IS THE FEDERAL FUNDS RATE IN THE U.S. THIS IS SEEN BY MANY AS THE BELLWETHER. INVERTED YIELD CURVE WITH HIGH SHORT-TERM RATES ALSO CITED AS FACTOR TENDING TO KEEP ARAB FUNDS AT SHORT END OF THE MARKET. OTHER ELEMENTS MENTIONED ARE ARAB FINANCIAL MENTALITY (THEY WANT TO KNOW FUNDS ARE IMMEDIATELY AVAILABLE) AND TO LESSER DEGREE, POSSIBLE LACK OF SKILLED, SOPHISTICATED MANPOWER IN INVESTING

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COUNTRIES NECESSARY TO MAKE AND SUPERVISE TERM RATHER THAN CALL INVESTMENTS. MANAGER OF ONE OF LARGEST U.S. BANKS HERE REPORTS THAT DESPITE LOW BIDDING, HE MAY STILL RECEIVE FROM \$500 MILLION TO \$1 BILLION ON A GIVEN DAY, AT CALL. THIS SOURCE, ALONG WITH A MAJOR U.K. INVESTMENT BANK, ATTRIBUTES INADEQUATE ARAB MONEY MANAGEMENT, POOR TELETYPE FACILITIES AND FEAR OF HAVING FUNDS BLOCKED FOR POLITICAL REASONS AS IN PART BEING RESPONSIBLE FOR THE CALL PLACEMENT PHENOMENA. THESE SOURCES CHARACTERIZE ARAB MONEY MANAGERS AS QUOTE SCARED, OVERWORKED EMPLOYEES UNQUOTE WHO ARE RIDING THE CREST OF A WAVE, TRYING TO PLACE THE FUNDS, NOT WORRYING ABOUT THE RATES THEY ARE PAID. HOWEVER, NOT ALL SOURCES HERE WOULD AGREE WITH THIS LIMITED OFFICIAL USE

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ANALYSIS, ESPECIALLY ABOUT LACK OF SOPHISTICATION.

4. SOME BANKERS EXPRESS CONCERN OVER THEIR ABILITY TO HANDLE FUNDS RESULTING FROM MID-JULY OIL PAYMENTS TO ARABS. THEY ARE CONCERNED WITH DECREASING CAPITAL ASSET RATIOS. SOME CONSIDER THAT WHAT IS NEEDED IS AN INTERNATIONAL DISCOUNT FACILITY FOR THEIR EURO-LOANS TO GOVERNMENTS FOR BALANCE OF PAYMENTS PURPOSES. AS NOTED, WE ARE TOLD MUCH OF THE CALL MONEY BEING RECEIVED HERE IS BEING CHANNLED BACK TO U.S. FEDERAL FUNDS MARKET, WHICH SOME CLAIM THUS FAR REPRESENTS THE SAFETY VALVE IN THE SYSTEM. OTHERS SAY PART OF ARAB FUNDS BEING RECEIVED IN BOTH LONDON AND NEW YORK ARE EVENTUALLY FINDING THEIR WAY INTO LONDON DOLLAR CD MARKET. A FEW MAJOR U.S. AND U.K. COMMERCIAL BANKS REPORT SEEING SOME LONGER TERM (5-7 YEAR) ARAB PLACEMENTS, BUT SMALL IN COMPARISON TO FLOWS AT SHORT END OF MARKET.

5. ATTITUDE OF U.S. BANKS IN OFFERING FUNDS HAS STIFFENED DURING PAST MONTHS WITH NO SIGN OF CHANGE. U.S. BANKS ARE NOW LOOKING FOR AT LEAST A THREE-QUARTER PERCENT MARGIN OVER LONDON INTERBANK OFFER (LIBO) AS A MINIMUM. THEY ARE BEING VERY SELECTIVE IN WHO THEY LEND TO. A MULTI-TIERED MARKET ON SYNDICATED BANK LENDING IS ALSO APPARENT. WE ARE TOLD RECENT \$200 MILLION SUDANESE GOVERNMENT ISSUE UNCONDITIONALLY GUARANTEED BY SAUDI ARABIAN MONETARY AGENCY (SAMA) WAS DONE AT THREE-QUARTER PERCENT OVER LIBO. SUDAN CURRENTLY IS SEEKING ANOTHER LOAN WITHOUT SAMA GUARANTEE AND REPORTEDLY MAY HAVE TO PAY MARGIN ABOUT TWICE AS LARGE (ABOUT 1-1/2 PERCENT) BECAUSE OF GREATER RISK. FOR CORPORATE BORROWERS, WE ARE TOLD RECENT SYNDICATED LOANS FOR TANKER CONSTRUCTION RELATIVELY EASY TO PUT TOGETHER. SOME U.S. BANKS ARE REDUCING OPERATIONS OF THEIR U.K. SUBSIDIARIES (I.E. LIMITED COMPANIES) INITIALLY SET UP TO UNDERTAKE MERCHANT BANKING AND RISKIER

SYNDICATED BANK LENDING OPERATIONS THAT THE U.S. PARENT DID NOT WANT ON ITS OWN BOOKS. HOWEVER, BANKERS HERE REPORT THAT ARRANGING A SYNDICATED LENDING OPERATION IN LONDON IS STILL QUICKER AND LESS COMPLICATED THAN RAISING A SIMILAR SUM IN THE U.S. MARKET, TAKING INTO ACCOUNT U.S. PRIME RATE, COMPENSATING BALANCES AND DIFFERENT LEGAL LIMITED OFFICIAL USE

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INSTRUMENTS.

6. BANK OF ENGLAND (BOE) JUNE QUARTERLY BULLETIN AND FIRST QUARTER U.K. B/P DATA CONFIRMED SOME DETAILS ABOUT ARAB FLOWS INTO STERLING. IN FIRST QUARTER OF 1974, INCREASE IN OFFICIAL RESERVES IN STERLING OF 263 MILLION POUNDS WAS MORE THAN ACCOUNTED FOR BY MUCH LARGER STERLING RECEIPTS OF THE OIL PRODUCING COUNTRIES. AS USUAL, HOWEVER, ONLY SOME OF THESE RECEIPTS WERE RETAINED IN STERLING. BOE ESTIMATES PERHAPS OVER ONE-QUARTER OF THE PAYMENTS TO OIL PRODUCING COUNTRIES FOR CRUDE OIL IS MADE IN STERLING (MARKET ESTIMATES OF STERLING PERCENTAGE HAVE RANGED BETWEEN TWENTY TO THIRTY PERCENT). THE RISE IN OIL PRICE HAS PRODUCED LARGE INCREASE IN STERLING TRANSACTIONS. AMOUNTS PAYABLE ON SOME DAYS ARE VERY LARGE. NON-U.K. OIL COMPANIES WHICH ACCOUNT FOR NEARLY ONE-HALF OF STERLING PAID TO THE PRODUCING COUNTRIES HAVE HAD TO INCREASE THEIR PURCHASES OF STERLING AND HAVE SPREAD THEM OVER A LONGER PERIOD IN ORDER TO AVOID MARKET DISTURBANCES. STERLING EXCHANGE RATE HAS BENEFITED, AND BECAUSE COMPANIES NOW HOLD MORE STERLING ON AVERAGE THAN PREVIOUSLY, PRIVATE STERLING BALANCES ALSO EXPECTED TO INCREASE. THUS FAR, BOE CONSIDERS U.K. MONEY MARKETS HAVE ABSORBED INCREASED FLOWS WITHOUT NOTICEABLE DIFFICULTY, ALTHOUGH U.K. BROKERS TELL US THIS IS NOT ALWAYS THE CASE. THERE HAVE BEEN INSTANCES WHEN SUSPECTED ARAB FUNDS FLOWING TO THE GILT MARKET THROUGH SWISS AND FRENCH BANKS HAVE HAD A NOTICE-ABLE IMPACT ON PRICE OF GILTS.

7. BY WAY OF EXAMPLE, U.K. BANKING AND MONEY MARKET LIA-

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BILITIES ON OFFICIAL ACCOUNT TO MIDDLE EAST OVERSEAS
STERLING COUNTRIES WHICH INCLUDES KUWAIT AND PERSIAN GULF
TERRITORIES INCREASED (IN MILLIONS OF POUNDS) FROM 595 IN
DECEMBER 1973 TO 809 IN JANUARY, THEN FELL TO 658 IN
FEBRUARY AND 616 IN MARCH. PRIVATE MIDDLE EAST HOLDERS
DECREASED STERLING HOLDINGS FROM 149 IN DECEMBER TO 119
IN JANUARY. EXTERNAL LIABILITIES OF U.K. BANKS IN FOREIGN
CURRENCIES TO MIDDLE EAST HOLDERS SHOWED INCREASE (IN
BILLIONS OF POUNDS EQUIVALENT) FROM 1.8 IN DECEMBER TO 2.7
IN MARCH. DETAILS AND DEFINITION IN JUNE BOE QUARTERLY
BULLETIN, TABLES 23-25 (SEE LONDON A-545).

8. BANKS HERE CONSIDER STERLING IS UNLIKELY TO SHOW MUCH
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IMPROVEMENT FROM CURRENT LEVELS BECAUSE OF RECORD TRADE
DEFICIT, SPECULATION ABOUT OUTCOME OF AN AUTUMN GENERAL
ELECTION, RAPID RATES OF INFLATION AND UNCERTAIN INDUS-
TRIAL OUTLOOK. IN ADDITION, STERLING INTEREST RATES MUST

MAINTAIN COMPETITIVE LEVEL WITH NEW YORK. FOR EXAMPLE, SHARP FALL IN STERLING/DOLLAR RATE MONDAY, JUNE 24, ALMOST ENTIRELY ATTRIBUTED TO STERLING INTEREST RATES WEAKENING AGAINST DOLLAR RATES. TO EXTENT POSSIBLE, DISCRETIONARY FUNDS MANAGED BY MAJOR U.K. CLEARING AND MERCHANT BANKS AND PENSION FUNDS HAVE BEEN SHIFTING OUT OF STERLING INTO DM AND DOLLARS. STEADY INCREASE IN INVESTMENT DOLLAR PREMIUM (AT \$2.60 RATE) FROM 40 PERCENT RANGE IN LATE APRIL TO 50 PERCENT RATE AT PRESENT SEEN AS REFLECTION OF THIS, AS IS REEMERGENCE OF BACK TO BACK LOANS AMONG INDUSTRIAL COMPANIES.

9. OCCASIONALLY WE QUERY ABILITY OF U.K. GOVERNMENT TO RAISE ANOTHER 2.5 BILLION EURODOLLAR ISSUE. THE GENERAL VIEW IS THAT A SIMILAR SUM COULD BE RAISED THROUGH THE CLEARING BANKS WITHOUT PARTICULAR DIFFICULTY, ALTHOUGH IF U.S. BANKS WERE TO PARTICIPATE ON AN ACTIVE BASIS, THEY WOULD WANT WIDER MARGINS THAN THOSE OFFERED IN THE FIRST LOAN, I.E. 3/8 FIRST TWO YEARS; 1/2 NEXT THREE; 5/8 IN THE 6TH AND 7TH; AND 3/4 IN LAST THREE. GENERAL MANAGER OF NATIONAL WESTMINSTER'S INTERNATIONAL DIVISION IS ON RECORD AS STATING THAT IF A SIMILAR LOAN WERE NECESSARY, IT COULD BE DONE, BUT IT WOULD HAVE TO BE MORE WIDELY SYNDICATED. WE HAVE HAD NO INDICATION THERE IS ANY ACTIVE CONSIDERATION FOR SUCH A LOAN IN THE CITY AT THIS TIME. THERE ARE WIDESPREAD RUMORS IN CITY THAT U.K. GOVERNMENT IS NEGOTIATING WITH ARAB COUNTRIES FOR DIRECT GOVERNMENT TO GOVERNMENT LOANS. IF TRUE, IT WOULD BE IN KEEPING WITH AIMS OF AT LEAST SOME BOE AND U.K. TREASURY OFFICIALS.

10. ABOVE REPRESENTS DISTILLATION OF VIEWS HEARD BY TREASURY REP DURING PAST THREE WEEKS, FOLLOWING UP ON REPORTING REFTTEL. IT REPRESENTS LENGTHY CONVERSATIONS WITH MAJOR U.S. AND U.K. BROKERAGE AND COMMERCIAL AND INVESTMENT BANKING SOURCES. VIEWS HEARD HAVE NOT BEEN UNIFORM. ALTHOUGH THEY COME FROM USUALLY HIGHLY RELIABLE AND SENIOR SOURCES, THEY SHOULD BE TAKEN WITH A GRAIN OF LIMITED OFFICIAL USE

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SALT BECAUSE NO ONE HERE SEES THE ENTIRE PICTURE. SIMILAR INFORMATION UNDOUBTEDLY EXISTS IN NEW YORK AND OTHER MAJOR CONTINENTAL FINANCIAL CENTERS. ABOVE IS OFFERED AS OUR BEST ESTIMATE ON HOW THESE ISSUES CURRENTLY SEEN FROM THE LONDON FINANCIAL MARKET.

11. DEPARTMENT PASS TO OTHER INFO POSTS AS DESIRED.

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